ACCOUNTS & FINANCE SECTION

STAFF TESTIMONY

COMMONWEALTH EDISON COMPANY

DOCKET No. 82-0026

CONTENTS

WITNESS QUALIFICATIONS

My name is Edward Bodmer and my business address is 527 East Capitol Avenue, Springfield, Illinois 62706.

I have been employed by the Illinois Commerce Commission, Public Utilities Division, Accounts and Finance Department since June, 1979.

I graduated from the University of Illinois Urbana Campus in May of 1979 with a B.S. degree in Finance. I also earned the equivalent of a B.S. in economics and completed 17 credit hours of mathematics.

I graduated with highest honors and a 5.0/5.0 scholastic average. I was awarded University Honors and the Bronze Tablet in 1979. I was elected to the Beta Gamma Sigma honorary business fraternity as a junior and I won the "Scholarship Key Award" given by the Alpha Kappa Psi professional business fraternity as a senior.

My work at the Illinois Commerce Commission has been principally in the area of computer applications to financial analysis in regulation. In this regard I have done substantial work on the Commission's financial forecasting model and I have given seminars at the Energy and Environmental Systems Division of Argonne National Laboratory and

and the NARUC Subcommittee on Computers and Economics. I have been appointed session chairperson for the topic of AFUDC vs. CWIP at next September's NARUC bienial Regulatory Information Conference. I have testified on cost of capital in Union Electric Company Docket 80-0370, and Continental Telephone Docket 81-0114. I have also testified on CWIP in the rate base vs. AFUDC in Illinois Power Dockets 80-0167 and 80-0544 utilizing a computer simulation model. I have also testified concerning excess reserve capacity in Docket No. 80-0519.

Purpose of Staff's Testimony

The purpose of Staff testimony is to ensure that the Commission is provided with pertinent information regarding a case and, where appropriate, provide objective, independent, recommendations to the Commission.

Introduction and Summary

Since February, 1980 the Illinois Commerce Commission has granted Commonwealth Edison Company a total of $893.2 million in permanent rate increases. Much of the reason for this relief has been Edison's substantial construction program which has created significant financing requirements during periods of historically tight credit and volatile money markets. Due to increased interest charges (with the resultant higher embedded debt cost) and poor financial integrity, Edison's construction program is again a significant driving force behind the Company's current interim request. Considering the current state of financial markets, the magnitude of the Company's construction program, and past rate increases, creativity is required on the part of the Commission, the Company, and other parties if maintenance of Edison's long run ability to provide adequate electric service to its customers is to be ensured. It is my position that because of the amount of financing and construction Edison is currently projecting, the

Commission's decision on the current interim proceeding will have significant long-term impacts. Although evaluating the long-run is of great difficulty, it is my opinion that in this case long-term phenomena simply cannot be disregarded.

This testimony provides a framework by which the Commission can study both long and short term impacts of its interim decision. This framework will include discussion of:

- Edison's construction program
- LaSalle Unit #1 revenue requirements
- Financial Ratios
- An Evaluation of Edison's forecast
- Edison's Capital Structure
- Additional cash sources
- Edison's AFUDC rate
- Rate relief in excess of amounts associated with LaSalle Unit #1.

Edison's Construction Program

As previously noted, Commonwealth Edison's construction program is a significant driving force behind the Company's current request for interim rate relief. Exhibit AF-1 demonstrates that in absolute terms, Edison's construction program is enormous. The Exhibit, derived partially from a response to a data request and partially from the Compustat data base, demonstrates that as of the third quarter of 1981, Edison's level of Construction Work in Progress (CWIP) exceeded that of any other investor-owned utility by $1.423 billion (representing 41.7% more than the next highest company). The exhibit also demonstrates that only 16 electric utility companies have net electric plant greater than Edison's CWIP (where net plant includes CWIP). As a result of this situation, although a few smaller companies might have construction programs larger relative to their net plant than Edison's, Commonwealth Edison Company -- as a single entity -- has had to, and must continue to, float more and larger issuances of debt and equity than other electric firms. Due to the sheer size of Edison's financial requirements, the Company's financial flexibility can easily become quite restricted (See tr. page 334).

Within the order in 78-0646 it is stated in part:

> "The Commission is of the opinion that the incremental engineering economic studies conducted by Edison and the full revenue requirements studies conducted by the Com-

mission's Staff demonstrate that substantial economic benefits will accrue to the ratepayers and the Company by completion of the Braidwood Station in as timely a manner as possible. This is true even though completion of the plants currently under construction will increase Edison's reserve margins."

Even if the Commission were to change its position, as stated above, and order Edison to halt the construction of four or five of its nuclear units, the massive CWIP investments would not disappear. If the Commission instructed Edison to suddenly cease construction, ratepayers would either have to directly provide revenue requirements for the carrying charges on this CWIP, or the Company could not survive in its present form because of the financial implications of capital charges on the investment. In either case, the future rate relief and/or service cuts required from customers could be significant.

Commonwealth Edison Company contends that their CWIP investment along with additional cash expenditures of $1.68 billion[1] will result in sizable fuel savings (approximately $1.3 billion per year). While it seems there is a question as to whether Edison's construction program is affordable, these numbers suggest that to cease all generating plant construction today is even less affordable.

Recommendation

Without a complete re-evaluation of the results and conclusions

[1]This figure compares with a figure of $2.77 billion for "all other" construction expenditures (Edison Exhibit 3, Schedule S-1).

discussed in Docket #78-0646, it cannot be stated that significant cuts in construction expenditures are a desirable course of action at this time. Furthermore, one must note that if Edison were to act contrary to the finding in Docket 78-0646 where it was stated that, "Edison has a duty to its ratepayers to complete the Byron and Braidwood Stations in as timely and economic a manner as possible", and cease or delay expenditures on the Braidwood units alone, the beneficial effect on Edison's financial condition would not be very significant. Exhibit AF-2 demonstrates that cutting Braidwood expenditures down to zero would only increase coverage ratios by .02 times, or approximately 1.5% in 1982 and 1983.

LaSalle Unit #1 Revenue Requirements

In Edison's last rate case (Docket #80-0546), the Commission authorized the Company to increase its tariffs once LaSalle Unit #1 was placed into service. This provision was subject to various restrictions among which was a prohibition of Edison's filing a rate case before the unit became operational. In its order, the Commission noted that operation of the unit would result in a net savings to the ratepayer once the unit became commercial due to an approximate $200 million annualized reduced fuel cost from nuclear generation displacing coal and oil fired generation as well as purchased power.

Although $708 million of CWIP associated with this unit is already included in rate base, significant costs associated with

the unit are not recovered in current rates. Specifically items including $52.5 million of depreciation, of $15 million O & M expenses, $5.3 million of insurance, $4.2 million of real estate taxes, and a return on rate base of $590.8 million currently accruing AFUDC are currently not encompassed in present tariffs. Grossed for income taxes and revenue taxes, these items create an annual revenue requirement of $213 million. If LaSalle does not become operational until September 1st, however, this rate increase only adds $62.11 million to 1982 revenues.

It is my opinion that unless revenue requirements from LaSalle Unit #1 are keyed to the in-service date of the unit, ratepayers will receive distorted price signals. If rate relief associated with the LaSalle #1 unit were granted before the unit became operational, ratepayers would receive higher bills for a period of a couple of months only to have rates subsequently lowered through fuel clause savings. If, on the other hand, revenue requirements associated with LaSalle Unit #1 were delayed for a period of months subsequent to the in-service date of the unit, customers would receive fuel savings without incurring the costs associated with these savings. For purposes of the interim case, keying some revenue relief to the in-service date of LaSalle has further logic:

- The expenses related to LaSalle will cause a downturn in many of Edison's financial ratios. Granting rate relief on dates before or after the inservice date

of the unit would lead to fluctuations in financial ratios which could be misinterpreted by the financial community.

- When the Company records additional depreciation due to the LaSalle Unit #1, this depreciation will be accumulated and deducted from rate base for many years into the future, representing cash flow for capital recovery provided by ratepayers. Unless rate relief is tied to LaSalle's inservice date, future rate base deductions of accumulated depreciation will represent a mismatch of recovered operating expenses and rate base deductions.

- It is obviously in the best interests of ratepayers to have LaSalle become commercial as early as possible. Keying rate relief to LaSalle's inservice date creates an additional incentive for Edison to have the unit become fully operational.

On the date LaSalle Unit #1 is placed into service for accounting purposes, a bookkeeping entry will be made to transfer LaSalle from CWIP to Plant in Service. On this date any CWIP included in rate base associated with the LaSalle Unit #1 is effectively removed. In Docket #80-0246 where the Commission allowed CWIP to be included in rate base, the Commission stated in part:

"In this case, as in the prior case, the Commission finds that the high percentage of AFUDC to Edison's total earnings is adversely affecting Respondent's financial integrity. The impact on other financial ratios is discussed under "Rate of Return." The continuing need to seek external financing, and the higher cost of such financing, works to the disadvantage of both the ratepayers and the shareholder."

Many of Edison's financial ratios continue to be at comparatively low levels and AFUDC remains high as a percent of Edison's total earnings. It is my opinion that CWIP in rate base remains a mechanism by which the financial integrity of a company can improve while simultaneously long-run costs can be reduced to rate payers.

Recommendation

In summary, Staff recommends that rates be increased on an annual basis by $213 million when LaSalle Unit #1 is placed into service for accounting purposes. These incremental revenue requirements will approximately offset the related fuel savings from the unit and rate-payers bills should still not be noticeably different. The fact that incremental revenue requirements from LaSalle Unit #1 approximately offset fuel savings does not suggest that total rates have been un-affected by the building of LaSalle Unit #1 (for example embedded debt costs have increased due to construction expenditures for the generating

plant) nor does it suggest that nuclear power is cheaper than other energy sources or vice versa. There is little doubt that the underlying reasons for which CWIP was allowed in rate base in Docket #80-0546 have not changed enough to warrant removing the CWIP from rate base. The Commission should thus consider -- either when LaSalle Unit #1 becomes operational or earlier -- allowing portions of LaSalle Unit #2 to be included in rate base and ceasing AFUDC on any amounts so included.

Financial Ratios

Traditionally, establishment of tariffs in a rate case has been confined to the determination of costs which are currently experienced (or will be experienced) in the production of public utility services. The mechanism for establishing these costs -- the revenue requirement -- has historically been derived from test year expenses plus a fair rate of return on a rate base. Discussion of cost of capital in this "traditional model" has principally been limited to measuring the cost of equity capital which is applied to a capital structure in deriving the rate of return figure. Due to Commonwealth Edison's construction program and the current state of financial markets, the "traditional model" has lost much of its applicability for this Company. It is my belief that the present situation requires significantly more input than simply measuring cost of capital, test year expenses and a rate base. Rather, Staff must evaluate the long-run and short-run effects of Edison's rate request on both ratepayers and the financial

condition of the utility corporation. Commissioner Stalon noted this in a concurring opinion to the interim rehearing order in Docket #79-0214:

> "However, in determining the need for an interim rate increase justified by financial stringency, the evidence needed is company-wide. Advertising expenses disallowed in normal rate making procedures must be recognized in such cases. Non-jurisdictional revenues, expenses and incomes normally overlooked in a rate case may become important in a financial stringency case. The definitions of interest, taxes, depreciation, income, expenses, etc. relevant for a financial stringency case are not the pro forma ones of rate making but those of indenture contracts and SEC and bond rating agencies."

Varying levels of interim relief not only impact the cost of capital, but also the amount of capital which must be raised externally and the flexibility with which the company can issue the capital instruments. These capital attraction effects have very important impacts on both rate payers and the utility company because:

(1) Current costs of debt and preferred capital are substantially above historical costs. Thus each new debt or preferred issuance impacts embedded interest rates and eventually impacts revenue requirements.

(2) Since market-to-book ratios are likely to continue at levels below one, each new equity issuance reduces book value per share and, theoretically, tends to increase the cost of equity over the long-run.

(3) If financing problems force Edison to give up on substantial amounts of their construction program and to be unable to complete certain plants, the results could be painfully expensive for both Commonwealth Edison and its ratepayers, even more expensive than timely completion of the plants.

In its financial analysis, the investment community evaluates Edison based on a set of financial ratios derived from the Company's corporate financial statements. Affecting these financial ratios directly impacts the investment community's perception of Commonwealth Edison Company and thus directly impacts costs of capital on any new financings. If the Commission chooses to ignore these ratios, it must accept risks of forcing Edison to raise additional capital at higher costs, and possibly forcing the Company to be unable to comply with the Commission's order in Docket #78-0646. On the other hand, if the Commission chooses to set rates by attempting to affect financial ratios certain other factors have changed. First of all, shifting expenses or rate base items from "above the line" to "below the line" becomes an exercise in obfuscation; in the current situation the Commission has effectively lost the ability to shift the burden of certain

items such as advertising to stockholders through accounting adjustments. (See tr. page 682) Secondly, if the Commission regulates using financial ratios only when times are bad, and regulates at the operating income level during other periods, the Company and its investors may gain certain windfalls. For example if the Commission is forced to compensate for income earned from subsidiary companies when these investments earn less than Edison's overall return, and not when they earn more than the overall return, investors have gained such a windfall. Additionally, the Commission must be careful to choose which set of financial ratios it wants to affect and exactly how it wants to affect them. Staff suggests that many different ratios can be affected by a myriad of influences other than rate relief -- many of these influences have been traditionally left to the discretion of management. Finally, evaluation of prospective financial ratios requires the utilization of corporate forecasts which must be carefully reviewed by the Commission's Staff and other interested parties.

Recommendation

It is my opinion that due to the importance of timely and cost effective completion of Edison's construction program, the Commission is virtually forced to examine various financial ratios. However if the Commission chooses such a course of action, certain other changes must also be employed:

- Given that the Commission has lost the ability to shift the burden of certain items to stockholders, if

the Commission does not believe Edison should engage in some expense or expenditure (whether or not this is directly related to providing utility service) the Commission must order the Company to cease, and the Company must cease, cash outlays for such activities. If Edison refuses to make such cuts, the Commission cannot regulate by attempting to affect financial ratios. Specific expense items will be discussed in Mr. Gorniak's testimony.

- Since financial ratios incorporate items which have been traditionally considered "below the line", the Commission must explicitly consider many of these items. For example, the Commission has effectively lost any ability to use a normalized capital structure and must directly consider total interest expenses rather than just interest allocated to plant in service.

- Since comprehensive financial forecasts must be evaluated for purposes of this particular case, similar corporate projections should also be evaluated over the long-term.

Subsequent sections of Staff testimony will consider the above factors.

Evaluation of Edison's Forecast

In Edison's last interim case, Docket #80-0546, Staff presented exhibits very similar to those submitted by Mr. Schultz in this case. These exhibits were based on financial forecasts submitted by the Company. Although Edison's witness Luftig testified:

> "Q. Mr. Luftig, how would you evaluate Commonwealth Edison's past performance in projecting its financial conditions? Have they been overly optimistic, or pessimistic?
>
> A. The only forecast as far as financial conditions that Commonwealth has made that I've been privy to have been those filed in rate proceedings over the last few years. And they've been amazingly accurate." (Tr. page 704),

fifteen months after the last interim order Staff finds that Edison's forecasts were quite optimistic. Staff notes furthermore that a Salomon Brothers report dated August 10, 1981 predicted Edison's year end 1981 earnings per share of $3.30-3.45; this compares with the actual level of $3.06 (See page 2 of Exhibit AF-3). Exhibit AF-3 shows further that many financial ratios actually turned out to be worse than Edison had forecast in the last case <u>with no rate increase</u>. Although the Company is able to reconcile differences between their

projections and actual figures, whether the forecasts which Edison has submitted in the current case are better than those of the last case is a question which must be evaluated by Staff. Review of the Company's data for reasonableness and accuracy, however, is necessarily limited by time constraints in an interim proceeding.

In order to check certain of Edison's figures, I have employed a computer simulation model, the results of which are shown on Exhibit AF-14. With the exception of Revenues and Operation and Maintenance Expenses (Including Fuel and Purchased Power), all of the items on the income statements are calculated in some manner by the computer program. Although many of the inputs to the model are derived directly from Commonwealth Edison's exhibits, running the program, by necessity requires Staff to use Edison's figures and check whether the numbers "fit together".[2] Given Edison's assumptions of interest rates, sales growth, and inflation, Edison's forecasts appear to be reasonable although Staff believes the AFUDC rate is understated in Edison's projections. However, Staff does have concerns regarding the Company's sales growth and operations and maintenance expense projections.

Sales Growth

In the past two years, Commonwealth Edison's sales forecasts have a track record of being quite optimistic. (Tr. page 1086) Although Staff is making no attempt to project an alternate level of sales in

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[2] Exhibit AF-14 explains how the model works and what inputs were used. The exhibit also contains a sample run.

this case, we note that Edison's numbers assume an end to the current recession early this summer. It is also noteable that the company does not incorporate price elasticity in simulating varying levels of interim rate relief. Although as a part of this short interim proceeding we cannot make an attempt to estimate the sensitivity of Edison's load growth to changes in the real price of electricity, the Staff is making two propositions:

(1) Edison's demand is not perfectly inelastic.

(2) Because Edison's sales are sensitive to price, the beneficial impacts of a rate increase on the financial condition of the Company may be partially offset.

In this regard, we note that a decrease of 3% in KWH sales from current projections reduces mortgage coverage by more than 10.8% (Edison Exhibit 2AB 1.4) while a full interim revenue increase of $400 million only raises this ratio by 31.7%. In short, levels of Edison's sales have a very important effect on its overall financial condition.

Due to price elasticity and the importance of Edison's construction program, Staff believes the Company must do everything possible to reduce both operating and non-operating expenses so as to minimize requirements for rate increases if it will be able to complete construction.

Operations and Maintenance Expenses

There is little question that Commonwealth Edison Company is facing financial difficulties and that Edison's ratepayers have already made substantial sacrifices in the form of rate increases. The Company must do everything possible (other than cutting generating plant construction) to keep expenses (and thus rates) low in these difficult times. In 1979, before recent rate increases, the Commission stated in its interim order:

> "This Commission encourages Respondent to meet the ratepayers part way by taking its own steps to improve its financial condition by cutting expenses."

In the present case, Staff is troubled by two facts regarding Edison's forecast of operations and maintenance expenses:

(1) Towards the end of Edison's last rate case Docket #80-0546, Edison estimated operations and maintenance expenses for the year ended June 30, 1982 at a level of $768.2 million. Currently Edison is projecting a level of $805.3 million. Staff regards the $37 million difference as a significant margin of error.

(2) On Edison Exhibit 2, Schedule C-1, Page 1 and 2, Edison shows an increase in operations and maintenance expenses other than fuel and purchased power of over $119 million from 1981 to 1982 -- an increase of approximately 16% amounting to a substantial real increase. Similar increases for the year 1978-1981 are shown in Exhibit AF-5. Although Mr. Gorniak will attempt to analyze certain specific expenses, a 16% increase in these expenses at this time appears quite high. Edison must do everything to cut cash operating expenses and defer as many programs as possible until the Company's reliance on externally generated funds is reduced.

As part of the main case, audit Staff will remove from revenue requirements any programs or expenses which we feel can be deferred.

Capital Structure

When the Commission considers a rate request, there are numerous different financial ratios which could be evaluated. These include various interest coverage ratios, profitability ratios, "cash flow" ratios, and earnings quality ratios. The levels of these ratios and the interrelationships among the various financial indicators depend on many factors other than the amount of rate relief granted by this Commission. Unlike the determination of capitalization return on equity, the Commission cannot make adjustments to capital structure, test year expenses, and the rate base to affect "real" financial ratios. If the Commission believes Edison's capital structure is not appropriate, it cannot make a normalizing adjustment in order to affect any of the ratios.

Edison's financial vice president testified that first mortgage debt is the most important financing vehicle for completion of its construction program:

> "Q. Which is the most important to the company to enable it to continue to finance its construction program, a bond derating, common stock pressure or the ability to float preferred stock?
>
> A. The senior security is the keystone security insofar as determining the merits of the, let's say, lesser security.

But I don't quite see how market pressure is in that series of items.

Q. So first mortage bond would be the most important?

A. First mortgage bond is, indeed, the most important." (tr. page 524)

This witness also testified that the ability to sell these bonds is contingent on bond ratings and interest coverage ratios (Edison Exhibit 1A page 12). These statements suggest that unless the Commission provides the company enough revenue to maintain an "adequate" coverage ratio, Edison will not be able to continue financing its construction given the Company's current financing schedules.

In rough terms, any coverage ratio can be formulated as:

$$\frac{\text{Net income before interest expenses (plus or minus various adjustments)}}{\text{Interest Expense}}$$

Simple arithmetic suggests that a coverage ratio can be increased either by increasing the numerator (net income before interest) or by reducing the denominator (interest expense). Net income can be raised through increasing revenues or lowering operating expenses, while in Edison's case, reducing interest expense is almost impossible.

Increases in interest expense can only be minimized through fewer issuances of debt. Given a certain level of external financing requirements, reducing debt issuances can only be accomplished through increased equity sales.

Although Edison's witness Schultz suggested that the amount of equity which can be sold is limited by the marketplace, he also testified as follows:

"Q. Would it be correct to say that the Company could probably always find investors, provided it was willing to lower the price of its stock to whatever levels the market was willing to purchase them at?

A. Yes, the lower the price of the stock, there will be an investor that will be willing to buy. You could have a company that was absolutely bankrupt and somebody might be willing to pay 2 cents a share." (tr. page 328)

The Commission is certainly concerned about Edison's capital structure as witnessed by the record of the Company's most recent bond financing case. Commissioner Rosenblum noted in a concurring opinion in this Docket (#82-0010):

"If Edison is convinced that this Commission has been providing rate relief based mainly on interest coverages,

it has an incentive to maintain a low interest coverage which then becomes the basis of rate relief."

He also stated:

"The Commission's public discussion of this case, both in Chicago and Springfield, indicated that the Commission does not intend to commit itself to interest coverage regulation. If that is true, and I hope it is, the message to Edison is that this sale of debt is at Edison's risk."

If the Commission, in fact, ignores interest coverage ratios, continuance of Edison's construction program might depend on fewer bond sales.

Staff notes that capital structure proportions for 1981 have varied significantly from those forecast in the last interim case -- Exhibit AF-6 shows that the projected debt to capital ratio from the last case (with no rate increase) was 54.46% while the actual ratio (using First Boston formulas which include short-term debt) was 57.5%. Similarly, the company projected a 33.26% common equity ratio (with no increase) while the actual ratio turned out to be 31.8%. Exhibit AF-6 also demonstrates that if the capital ratios projected in the last case could have been attained, pretax interest coverage including AFUDC would have been 2.13 instead of 2.05 and return on equity would

have been 11.15% instead of 11.60%. Staff notes finally that Edison's forecasts reflect an earnings per share increase of 8¢ in 1982 over 1981 levels while interest coverage ratios decline -- certainly part of the reason for this phenomena is Edison's capital structure make-up.

Although, in terms of long-run cost, debt is theoretically cheaper than equity to ratepayers due to tax advantages, if completion of Edison's construction depends on a strengthened equity base, these tax advantages may well be overwhelmed by fuel savings and other economies. Unfortunately there is little question that completion of Edison's construction program is partially dependent on substantial rate increases; yet completion of the program appears to be also contingent on Edison's ability to increase its equity ratio. These capital structure issues were discussed by Standard and Poors when they recently downgraded Edison's bonds:

> "The rating reductions reflects Commonwealth Edison Company's continued weak level and quality of <u>fixed charge coverage</u>, resulting primarily from its heavy construction program. Financial flexibility remains impaired by a <u>highly leveraged capital structure</u> and the need for interim rate relief to enable the company to meet external financing requirements. Improvement in credit protection measures is anticipated,

assuming a favorable interim and general rate order in the current rate case. However, restoration to levels consistant with an "A-" senior debt rating is uncertain at this time and highly dependent on timely completion of construction projects; on going support of rate increases and a <u>strengthened equity base</u>." (emphasis added) (Edison Exhibit 1A-15)

Recommendation

It is Staff's opinion that Edison's debt to capital ratio should be reduced in 1982 and 1983 to levels lower than are reflected in Edison's current financing schedules. As a minimum, Staff recommends that any reduced external financing requirements resulting from an interim rate increase be used to reduce debt issuances. Furthermore, if Edison should gain any additional cash inflows (see next section), these should only be used to reduce debt financings. Finally, we note that since interim relief should take pressure off of common stock issuances (as Mr. Schultz testified) sales of common and preferred stock in addition to those currently scheduled could be ordered depending on the level of interim relief the Commission grants. Exhibit AF-8 highlights the effects of alternate capital structures in 1982 and 1983 assuming the Commission grants $391 million in rate relief. The exhibit demonstrates that Edison's profitability

ratios would be superior to industry averages while interest coverage ratios would remain worse than A averages. A way to partially rectify this situation is through an increased equity base.

Additional Cash Inflows

Staff Exhibit AF-7 demonstrates the savings which can accrue to ratepayers through reducing the amount of external financing requirements. The study shows that because embedded debt rates are lowered by at least ten basis points, the return on rate base can be reduced for a given return on equity. The differential in return on rate base in turn affects income taxes, revenue taxes, and future financing requirements. Other than through increases in rates, Commonwealth Edison Company could raise cash for construction through:

(1) Cutting operations and maintenance expenses above those already made,
(2) Selling certain assets,
(3) Utilizing the sale-leaseback provision under the Economic Recovery of Tax Act (ERTA),
(4) Cutting dividends,
(5) Raising rates to wholesale customers.
(6) Not increasing investments in subsidiary companies.

Cuts in expenses have already been discussed. A reduction in dividends would undoubtedly preclude any equity issue at a reasonable value per share for the foreseeable future and is not a recommended alternative.

Due to the severe cash flow problems of Commonwealth Edison, the Company must actively explore selling assets (including generating plant CWIP), selling tax benefits under the ERTA, ceasing investments in subsidiary companies and pursuing other rate relief. If the sale-leaseback provision of the ERTA is repealed, Edison should explore selling and leasing back both the book and tax basis of LaSalle. (See tr. page 515) Exhibit AF-10 shows that if Edison could get $200 million in cash for the sale of tax benefits, financial ratios could be increased substantially.

Recommendation

Staff recommends that Edison be required to submit reports as part of the main case detailing efforts to acquire cash and the reasons why certain actions were or were not taken. As discussed earlier we further recommend that any cash acquired be used to reduce debt issuances. Finally staff recommends that after any increases in dividends per share, the Company be required to submit a report detailing the costs and benefits of their new policy.

Allowance For Funds Used During Construction

Edison is currently factoring a return on equity of 17.5% into calculations of their AFUDC rate. Without interim relief however, the company's return on equity imputed to rate base assets is only 6.2%. The dichotomy between these two figures warrants further study since AFUDC is a very important consideration in many of the financial ratios and because AFUDC has important effects on future revenue requirements.

When the Commission generally sets rates, it grants a return on equity imputed to rate base through a capital structure. Whether this return can be earned or not, however, depends on revenue collections and expense levels actually realized by the company. If a company's actual expenses differ from the allowances set by the Commission, or if the company's actual revenues vary from what the Commission had calculated, the company can earn more or less than its allowed return. This so called prospective regulation creates significant incentives for a utility company to operate efficiently.

As opposed to return on rate base, the AFUDC rate is the result of a mathematical equation. The rate is simply multiplied by non-rate base CWIP assets in order to attain AFUDC income. This amounts to a guaranteed return as all of the AFUDC is charged eventually to ratepayers through depreciation expense. There is little doubt that

a high AFUDC rate is very expensive to ratepayers. Exhibit AF-9 demonstrates that lowering the AFUDC equity rate from 17.5% to 15.0% in 1982 and 1983 results in substantial future revenue savings. At a discount rate of 15% lowering the rate to 15% saves customers $73,000,000 -- or approximately .04¢ per Kwh after 1986.

Although AFUDC income is eventually realized by investors as cash through depreciation expenses, Edison's witnesses suggest that these non-cash earnings are significantly discounted by both bondholders and stockholders. Mr. Luftig testified for example:

> "In terms of AFDC? They're not looking at what it's earning, because they're not seeing any cash for it. What they're looking at is the percentage of AFDC to total earnings per share." (tr. page 697).

It is notable that Edison's first mortgage indenture coverage does not include AFUDC and that reductions in AFUDC actually improve certain earnings quality indicators.

Recommendation

It is Staff's recommendation that for purposes of the interim case, the Commission consider altering Edison's AFUDC rate. One possibility could be that Edison's AFUDC rates be brought in line

with the capitalization return on equity the Commission actually expects Edison to earn (these figures are reflected in Staff's computer runs and could be stated in an order). Another alternative would be to lower the AFUDC equity rate to a point at which an interim increase would not impact earnings per share. For example, if the interim grant would raise projected EPS by 30¢, the Commission might order Edison to lower the equity component of AFUDC so that accruals would be lowered by 30¢/share, thus leaving total shareholders returns unaffected, but giving the earnings better "quality". In the main case it is Staff's recommendation that the Commission should investigate the possibility of keying the AFUDC equity rate to construction efficiency.

The Need For Rate Relief

In Excess of Amounts Associated With LaSalle Unit #1

The Commission test for interim relief is as stated in Edison's last interim rate order Docket #80-0546:

> "The starting point for such an inquiry must be whether there are reasonable grounds for the Commission to believe that irreparable harm to the petitioning utility would result from the denial of the request for interim relief. In deciding this question, the Commission believes that there must exist an obvious revenue deficiency coupled with one or more of the following:
>
> > A sudden decline in revenues caused by factors outside the control of the utility; an inability to arrange debt financing or attract capital at reasonable costs without increased operating revenues; an evidentiary showing that deferral of partial rate relief until a final order can be issued would result in an unreasonable and harmful loss of revenue to the petitioning utility; and that reasonable grounds exist for the Commission to believe that the utility would be entitled to rate relief at the time a final order is issued."

Clearly these standards are quite subjective and some judgement is required on the part of the Commission. I have already discussed the harmful (possibly irreparably harmful) consequences of ceasing major portions of Edison's construction program. The general goal of the Commission should thus, in my opinion, be to keep Edison's revenues sufficient enough to continue construction. There are a number of specific ancillary objectives however which the Commission might consider in the attainment of this general goal:

(1) Maintaining Edison's Current Bond Rating,

(2) Maintaining Edison's ability to sell 1st mortgage bonds under current financing schedules,

(3) Maintaining Edison's ability to sell 1st mortage bonds under alternate financing schedules,

(4) Maintaining Edison's ability to issue junior securities.

Although all of these objectives are somewhat related, they are not necessarily mutually exclusive.

There is a possibility that another downrating on Edison's bonds could be avoided if Edison's ratios do not fall further. Mr. Luftig testified in this regard:

> "Q. So if Commonwealth Edison's interest coverage and other significant ratios were to remain at December 31, 1981 levels throughout 1982, do you think this would prevent a downgrading of their bonds?
>
> A. I don't know. It would be close. I think the agencies -- the rating agencies have to be doing forecasts right now on Edison, and they've got to be trying to forecast trends..." (tr. page 68)
>
> (This testimony occurred before the most recent downgrading)

On the other hand, Edison's goal of attaining financial ratios which are comparable to those of A-rated utility averages would certainly lessen chances of any further downgradings. If Edison's objective was accepted, the Commission would still have to decide by what date financial indicators would have to be attained and exactly which ratios should be considered most important.

Exhibit AF-8, page 2, shows that an interim grant of $391.6 million on April 1st (resulting in additional 1982 revenues of $277,400,000) would, by the end of 1982, hardly achieve third quarter 1981 industry BBB averages in terms of pretax interest coverage excluding AFUDC. On the other hand, the exhibit demonstrates that with the full increase, earnings per share would increase to $4.19 -- representing an almost 27% increase over the 1978 record level of $3.30.

To guarantee Edison the ability to issue 1st mortgage bonds would require more than 90% of their interim request on April 1st if all long term debt is assumed to be mortgage debt. If it is assumed that one of Edison's scheduled issuances in late 1982 is not 1st mortgage debt a lower percent of their request would maintain the indenture coverage. If issuances in August and October would not be first mortgage debt very little interim relief would be required to maintain a level of 2.50 times.

Clearly many factors must be taken into account in the Commission's final interim determination. Staff will thus recommend a wide range of rate relief in addition to the revenue requirements due to LaSalle Unit #1. The greater the amount of rate relief the better the financial ratios, the less the amount of money Edison is forced to raise externally, and the lower the cost of new money. Because the Company is currently in a position where any increases in taxable income increase investment tax credit utilization -- and little extra income tax is paid to the Federal government -- interim increases have a very beneficial effect on cash flow. By reducing financing requirements this cash flow aids financial ratios in the short-run and reduces revenue requirements over the long-run. The long run implications have already been discussed; the short-term financial benefits from reduced financing are shown on Exhibit AF-8, pages 4 and 5. Similarly increases in money costs have significant long-run effects. Exhibit AF-4 shows that an additional 100 basis points on long term debt and preferred issuances through 1985)whether due to a bond derating or issuance of junior-debt) will cost consumers $405 million over 34 years. At a discount rate of 15% this creates an additional ratepayer cost of $76,000,000. If AFUDC is adjusted so that earnings per share would be the same with or without interim revenues, this case theoretically results in no transfer of resources from consumers to stockholders and the only issue the Commission must tackle is the allocation of wealth between current ratepayers and future ratepayers. Staff believes such intergenerational equity questions are highly subjective and discretion must be left to the Commission.

Recommendation

Unfortunately Edison's financial condition remains very poor. As shown above in Exhibit AF-5 and supporting testimony the $503 million rate relief granted in Docket No. 80-0546 did not result in a reversal of unfavorable downward trending of many of Edison's financial indicators. Staff believes that further deterioration of certain of Edison's financial ratios in 1982 is unacceptable if construction is to be continued. As an absolute minimum annualized increases of $70 million on April 1st and $213 million on September 1st would be required to keep coverages at an even or an upward trend with no AFDC adjustments, given no further cuts in operation and maintenance expenses. The $70 million results in additional 1982 revenues of approximately $49.6 million and the $213 million increase results in 1982 revenues of $62.11 million. These total 1982 revenues of $111.71 are approximately 40% of Edison's requested realized revenues of $277.4 million in 1982 (see Exhibit AF-11). It must be emphasized that at this minimum range the Commission must accept very real risks of another downgrading, inability to issue debentures and the possibility of construction cutbacks.

In terms of financial ratios, a dollar less spent on expense items has exactly the same effect as a dollar in increased revenues. If Edison makes the cuts suggested by Mr. Gorniak, this will either tend to reduce the Staff's minimum range by $36 million or alleviate financial ratios given the minimum recommendation.